

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105**

INITIAL STATEMENT OF REASONS

Date: October 26, 2007

REG-2007-00045

SALES TO MILITARY PERSONNEL

INTRODUCTION

On September 29, 2006 President Bush signed into law the Military Personnel Financial Services Protection Act (the "Act"). 109 Pub. L. No. 290; 120 Stat. 1317. Section 9 of the Act states that it is the intent of Congress that "the States work collectively with the Secretary of Defense to ensure implementation of appropriate standards to protect members of the armed forces from dishonest and predatory insurance sales practices." Accordingly the National Association of Insurance Commissioners (NAIC) at its 2006 Winter National Meeting appointed a new Military Sales (EX) Working Group to assist state insurance regulators in achieving the directives set forth in the Act. The working group worked closely with Department of Defense staff, who along with other interested parties including insurance industry representatives, submitted comments on a draft model regulation that was first circulated on February 2, 2007. Successive revised drafts were circulated, and the working group received further public comments, until May 24, 2007, when the working group adopted the Military Sales Practices Model Regulation (the "Model"). On June 4, 2007 the NAIC unanimously adopted the Model

The Commissioner believes that the proposed regulations are necessary to carry out the purpose set forth in the Model: to set forth standards to protect active duty service members of the United States Armed Forces from dishonest and predatory insurance sales practices by declaring certain identified practices to be false, misleading, deceptive or unfair. For the most part, the text of the proposed regulations copies the language of the Model Regulation *verbatim*, with only nonsubstantive changes in grammar, format and numbering. In instances where substantive language has been added, in each case identified and discussed separately below, the change was necessary in each case in order to comply or avoid conflict with California law, to resolve ambiguities present in the Model Regulation and/or to make explicit an underlying principle of the Model Regulation.

To the extent that the proposed regulations contain the provisions of the Model they are reasonably necessary not only in order to carry out the intent of Congress but also in order facilitate an efficient and consistent regulatory framework governing sales to military personnel on a nationwide basis. Many insurers write life policies in multiple states. As of September 28, 2007 fifteen States had already adopted some form of the Model, and another fifteen States, plus the District of Columbia, planned to do so by year's end.

It can be beneficial to both insurers and consumers when administrative costs related to compliance with multiple, inconsistent regulatory requirements imposed by different states are reduced. The proposed regulations tend to serve this purpose by ensuring that California's regulatory requirements in this area are as consistent with those of other states as is possible under California law. To the extent that insurers, operating in compliance with California law, are able to devote additional resources — resources which could otherwise be devoted to satisfying multiple, inconsistent regulatory regimes — to improving their financial stability or providing better products to consumers, everyone stands to benefit. The proposed regulations are reasonably necessary to the degree to which they help to achieve progress toward this goal.

SPECIFIC PURPOSE AND REASONABLE NECESSITY OF REGULATION

The specific purpose of each adoption and the rationale for the Commissioner's determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed are set forth below.

SECTION 2695.20: PURPOSE

This section states the purpose of the Model: To set forth standards to protect active duty service members of the United States Armed Forces from dishonest and predatory insurance sales practices by declaring certain identified practices to be false, misleading, deceptive or unfair. This provision is reasonably necessary for purposes of clarity, because it identifies both the intent of Congress as specified in the Act — to protect service members from dishonest and predatory insurance practices — and the means by which the drafters of the model have sought to carry out Congress's intent: "declaring certain identified practices to be false, misleading, deceptive or unfair."

We have inserted into the text of this section the following sentence, not present in the Model: "However, no exemption, exclusion or silence in this article as to any act or practice shall be construed to suggest that such act or practice, when performed or engaged in by an insurer or insurance producer, is not otherwise in violation of underlying statute or other applicable law." This insertion is necessary in order to comply with the consistency standard of the Administrative Procedure Act (APA).

The Model does not purport to comprise a comprehensive list of all illegal acts or practices that could occur with respect to life sales to military personnel. Nonetheless, without the inserted language, various provisions of the proposed regulations could be interpreted as granting immunity to insurers or producers who violate California law. For instance, Paragraph (c)2 of Section 2695.26 specifies as false, misleading, deceptive or unfair the act of misrepresenting the mortality costs of a life insurance product; however, the paragraph explicitly excludes "individually issued annuities." This exclusion would be problematic were it not for the language we have inserted into Section 2695.20, since making such a misrepresentation with regard to individually issued annuities is indeed a violation of California statute, including but not limited to Insurance Code section 790.02. Similarly, Subdivision (a) of Section 2695.23 of the proposed regulations exempts various insurance products from the purview of Sections 2695.25, 2695.26 and 2695.27. Among the acts proscribed in these sections is, for

example in Paragraph (b)1 of Section 2695, using any device, title, descriptive name or identifier that tends to confuse a service member into believing, incorrectly, that the product, insurer or producer in question is affiliated with the military. However, Paragraph (a)(2) of Section 823.5 of the Military and Veterans Code (Stats. 2007, ch. 363, § 1 (AB 1526)) outlaws any such activity with regard to any financial product marketed by any person or entity licensed under the Insurance Code. Accordingly it would violate the APA's consistency standard to leave open the possibility that the proposed regulations, by exempting a particular product (credit insurance, as a case in point) from the purview of Sections 2695.25, 2695.26 and 2695.27, could provide a shield against prosecution arising from a violation of the Military and Veterans Code, which contains no such exemption.

In all other respects, the language of Section 2695.20 is substantially identical to that of the Model; this section is therefore reasonably necessary in order to carry out the purpose of the Model and/or the intent of Congress as expressed in the Act.

SECTION 2695.21: SCOPE

This section limits the applicability of the proposed regulations in terms of the range of insurance products to which they apply: life insurance products sold or solicited to active duty service members. It is necessary to express this limitation in scope so as to avoid possible confusion, for as example, as to whether sales of other lines of insurance, including property and casualty, not intended to come under the purview of the regulations will be impacted.

The Department has made two arguably substantive changes to the language of the corresponding section of the Model. Firstly, in order to satisfy the APA's consistency standard we have changed the phrase "any life insurance or annuity product" to "any annuity or other life insurance product." Insurance Code section 101 defines the term life insurance as including annuities, but the phrasing of the Model implies, through the use of the disjunctive "or," that annuities are something other than life insurance. Further, "life insurance" is defined in the model as including annuities. Secondly, we have excluded from the limitation on the scope of the proposed regulations that is announced in this Section 2695.21 the definition of the term "premium deposit fund" in subdivision (I) of Section 2695.24. This term is undefined in the model and, for reasons discussed below under SECTION 2695.24: DEFINITIONS, applies in California to a broader category of life products than those sold or solicited to military personnel.

Section 2695.21 is otherwise substantially identical to the corresponding section of the Model Regulation; this section is therefore reasonably necessary in order to carry out the purpose of the Model and/or the intent of Congress as expressed in the Act.

SECTION 2695.22: AUTHORITY

In keeping with the model, this section cites the statutory authority for promulgating the proposed regulations. However, it has been necessary to insert the word "express," so as to rule out the erroneous conclusion that the cited statutes represent the full extent of the Commissioner's authority to adopt the regulations. In California state agencies may adopt

regulations on the basis of authority that has not been granted explicitly by statute; agencies may proceed on the bases of implied and inherent authority, as well as express authority. Additionally, the Insurance Commissioner in particular enjoys broad discretion to adopt rules and regulations as necessary to promote the public welfare. *CalFarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805, 824 (1989); *20th Century Ins. Co. v. Garamendi*, 8 Cal. 4th 216, 245 (1994). In all other respects, the language of Section 2695.22 is substantially identical to that of the Model; this section is therefore reasonably necessary in order to carry out the purpose of the Model and/or the intent of Congress as expressed in the Act.

SECTION 2695.23: EXEMPTIONS

In conformity with the Model, this section lists certain classes and lines of insurance, and specifies certain insurance products, that are exempt from the substantive prohibitions announced in the Model. The Department has made two arguably substantive departures from the model, however, both in subdivision (a).

Firstly, whereas the Model does not specify particular sections of the Model as to which the exemptions apply, we have limited the exemptions' application to Sections 2695.25, 2695.26 and 2695.27 of the proposed regulations. These are the only sections that actually proscribe given acts or practices; consequently, exemption from these sections only is sufficient to ensure that the enumerated classes, lines and products are not impacted by the substantive prohibitions declared in both the Model and the proposed regulations. A potentially substantive effect of this change is to reduce the scope of the exclusions so that, unlike in the Model, the exclusions in the proposed regulations do not apply to the definitions stated Section 2695.24. This change is necessary in order to ensure that the proposed regulations do not run amuck of the APA's consistency requirement with regard the definition of the term "premium deposit fund" in subdivision (l) of Section 2695.24. As mentioned above, this term is undefined in the model and, for reasons discussed below under SECTION 2695.24: DEFINITIONS, applies in California to a broader category of life products than those sold or solicited to military personnel. The term "premium deposit fund" should have a consistent meaning throughout the Insurance Code and regulations promulgated thereunder. It would be unworkable if the term had one meaning in the case of a group life policy that happened to be sold, for instance, without face-to-face solicitation but another meaning if the same policy were sold by means of face-to-face solicitation; this would be the result if the exemption articulated in Paragraph (a)2 of Section 2695.23 were allowed to apply to the definitions in Section 2695.24 of the proposed regulations.

Secondly, we have changed the word "or" to "and" in Paragraph (a)2 of Section 2695.23. In doing so, we have arguably narrowed the scope of this exemption so that only group products that neither are solicited face-to-face nor include a side fund are exempt. The language of the model left open the possibility that the exemption would apply both to group products not sold by means of face-to-face solicitation and to group products that do not include a side fund. Thus, the unmodified language left room for the interpretation that any group product that did not include a side fund was exempted from the prohibitions articulated in the Model, so that the prohibitions would not apply even to group products that indeed were solicited face-to-face. This result is contrary to the intent of the working group who framed the model, as can be seen

in the minutes of the Military Sales (EX) Working Group conference call of April 19, 2007 where Bill Goodman, who co-chaired the meeting, indicated that the Model “covers group policies that are solicited face-to-face but does not apply to other group policies.” It not perfectly clear to which other group policies Mr. Goodman intended the Model not to apply, but it is reasonable to interpret the phrase “other group policies” to mean those that do not include a side fund, since the abuses associated with side funds are repeatedly decried in the NAIC’s Report to Congress entitled “Life Insurance Sales to Members of the Armed Forces” and GAO report number GAO-06-23 entitled “Financial Product Sales: Actions Needed to Better Protect Military Members,” which was released on November 17, 2005.

Section 2695.23 is otherwise substantially identical to the corresponding section of the Model Regulation; this section is therefore reasonably necessary in order to carry out the purpose of the Model and/or the intent of Congress as expressed in the Act.

SECTION 2695.24: DEFINITIONS

This section defines technical terms used in the proposed regulations. We have added definitions of the term “individually issued annuity” in subdivision (e) and the term “premium deposit fund” in subdivision (I). Section 2695.24 is in other respects substantially similar to the corresponding section of the Model Regulation; this section is therefore reasonably necessary in order to carry out the purpose of the Model and/or the intent of Congress as expressed in the Act.

Section 2695.24, Subdivision (e): Individually Issued Annuities

Appearing nowhere in either the Insurance Code or Chapter 5 of Title 10 of the California Code of Regulations, the term “individually issued annuities” is used repeatedly throughout the Model. The term is ambiguous on its face and consequently violates the clarity standard of the APA. Possible meanings include individual annuities, annuities issued in sequence, and annuities not connected to a life policy. We have chosen to resolve the ambiguity in favor of this last possibility, because doing so appears most nearly consistent with the intent of the model.

Section 2695.24, Subdivision (I): Premium Deposit Fund

This term is defined nowhere in either the Insurance Code or Chapter 5 of Title 10 of the California Code of Regulations, though it is used in Insurance Code section 10168 and in three sections of Title 10, Chapter 5: Sections 2544.2, 2542.3 and 2534.28. Each time the term is used in existing law, it signals a particular category of fund to which nonforfeiture law does not apply. The term is used in the proposed regulations only in the definition of the term “side fund,” discussed below. Pursuant to the definition of that term, a premium deposit fund meeting specified criteria is explicitly not a side fund. However, the definition of “side fund” itself is ambiguous unless the term “premium deposit fund” is defined. Hence, it is necessary for purposes of satisfying the APA’s clarity standard that “premium deposit fund” be given a definite meaning. Additionally, the APA’s consistency standard militates in favor of the term having the same meaning no matter where it appears.

The plain meaning of words of the phrase “premium deposit fund” indicates that it is a fund that contains “premium.” For guidance as to the meaning of the word “premium” we turn to Insurance Code section 480, where premium is identified as that thing the payment of which the insurer is “entitled to.” Thus, a premium deposit fund would appear to be a fund that contains required payments to the insurer under the terms of an existing insurance contract. This reading is consonant with Insurance Code section 10540, which distinguishes between moneys collected in advance or accepted for the payment of future premiums on issued policies, on the one hand, and funds accepted for the purpose of purchasing annuities at future dates, on the other. We have preserved this distinction in our definition of premium deposit fund.

It is necessary that the meaning of the term “premium deposit fund” be limited to funds containing only moneys, and accrued interest, to be used to pay future required payments and that the term exclude other funds, which may be used for other purposes. The Model accords to premium deposit funds meeting specified criteria a preferred status not granted, presumably, to other deposit funds that satisfy the same criteria. Similarly, Insurance Code section 10168 accords to premium deposit funds the advantaged status of being exempt from the requirements of the Nonforfeiture Law for Individual Deferred Annuities. It follows, therefore, that the term must represent some narrower class of funds than deposit funds generally. There is nothing improper about a premium deposit fund; this policy feature is, as has been noted, expressly authorized by Insurance Code section 10504. The problem arises when a premium deposit fund is designed or marketed as something in addition to or other than a vehicle for paying required premiums.

This is the essential feature of side funds that has prompted, in large part, the Congressional reaction from which the Model flows: that they are characterized as savings vehicles, investments or means of purchasing annuities, for instance, when they are first and foremost a way of making sure required premiums are paid. The problem is exacerbated when the money deposited in the fund is siphoned away by default to pay premiums on a life policy when the insured believed, understandably, that the funds were to be used for another purpose. There is thus incentive in both the Model and the Insurance Code for insurers to seek to characterize as premium deposit funds moneys that can be used for purposes other than for paying premiums on issued policies. For these reasons it is necessary to define the term “premium deposit fund” in such a way that will defy any possible attempt to characterize moneys that can be used for other purposes as falling with the meaning of the term.

SECTION 2695.25: PRACTICES DECLARED FALSE, MISLEADING, DECEPTIVE OR UNFAIR ON A MILITARY INSTALLATION

This section of the proposed regulations is substantially identical to the corresponding section of the Model. As such it is therefore reasonably necessary in order to carry out the purpose of the Model and/or the intent of Congress as expressed in the Act.

SECTION 2695.26: PRACTICES DECLARED FALSE, MISLEADING, DECEPTIVE OR UNFAIR REGARDLESS OF LOCATION

This section identifies acts and practices that are proscribed no matter where they take place. We have made two additions to the text of the Model that are arguably substantive. Section 2695.26 is in other respects substantially similar to the corresponding section of the Model Regulation; this section is therefore reasonably necessary in order to carry out the purpose of the Model and/or the intent of Congress as expressed in the Act.

Section 2695.26, Paragraph (f)4

We have added the requirement that life insurance products sold or marketed to members of the military must comply with the Standard Nonforfeiture Law for Individual Deferred Annuities, as well as with the Standard Nonforfeiture Law for Life Insurance, which is all that the Model required in this paragraph. In light of the proposed regulation's definition of premium deposit fund, this additional requirement will provide service members a heightened degree of protection against forfeiture, since side funds, as defined, will no longer be able to qualify for exemption from the Standard Nonforfeiture Law for Individual Deferred Annuities.

Section 2695.26, Paragraph (f)5

The language of the corresponding section in the model certainly fails of the APA's clarity standard, but the most likely meaning appears to be something nearly the opposite of what the working group intended. The minutes of the Military Sales (EX) Working Group's conference call of May 24, 2007 strongly suggest that the purpose of this language in the Model was to allow insurers to exclude only coverage for double indemnity payments in the event of accidental death related to war or military service. The added language eliminates the absurd possibility that a policy could be designed that would pay if the enemy actually succeeded in killing the insured (death related to war) but would not pay in the event death were due to "friendly fire" (accident).

IDENTIFICATION OF STUDIES

There are no specific studies relied upon in the adoption of this article. In adopting the proposed regulations the Department has relied upon NAIC's Report to Congress entitled "Life Insurance Sales to Members of the Armed Forces," dated March 29, 2007; the minutes of the Military Sales (EX) Working group conference calls of April 19, 2007 and May 24, 2007, respectively; NAIC's Second Report to Congress entitled "Life Insurance Sales to Members of the Armed Forces," dated September 28, 2007; and GAO report number GAO-06-23 entitled "Financial Product Sales: Actions Needed to Better Protect Military Members," which was released on November 17, 2005.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

ALTERNATIVES

The Commissioner has determined that no reasonable alternative exists to carry out the purpose for which the regulations are proposed. Performance standards were considered but were rejected as an unreasonable and impracticable alternative in the context of regulations that seek efficiently to define specific rules for the protection of service members being sold life insurance policies.

ECONOMIC IMPACT ON SMALL BUSINESS

The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department, that would lessen any impact on small business. Although performance standards were considered as an alternative, they were rejected, in part, because the kind of risks from which the regulations seek to protect consumers cannot practicably be gauged by means of a performance standard.

PRENOTICE DISCUSSIONS

The Commissioner has not conducted prenotice public discussions pursuant to Government Code Section 11346.45, because the many of the affected parties who would have been invited to participate in such discussions — primarily insurers — have been offered and, in some cases, have taken advantage of the opportunity to participate in the public comment process afforded by the NAIC in the drafting of the Model. Additionally, it is unlikely that the interested parties will find the modifications made by the Department to the language of the Model to be too complex or multifarious to be reviewed easily during the comment period.